

SURREBUTTAL TESTIMONY AND EXHIBIT OF

MATTHEW P. SCHELLINGER II

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2018-82-S

IN RE: APPLICATION OF PALMETTO WASTEWATER RECLAMATION, LLC

FOR ADJUSTMENT OF RATES AND CHARGES

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Matthew P. Schellinger II. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the Office of Regulatory Staff (“ORS”) in the Utility Rates and Services Division as a Regulatory Analyst.

Q. DID YOU FILE DIRECT TESTIMONY AND EXHIBITS RELATED TO THIS PROCEEDING?

A. Yes. I filed direct testimony and five (5) exhibits with the Public Service Commission of South Carolina (“Commission”) on March 12, 2019.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony filed by Palmetto Wastewater Reclamation LLC (“PWR” or “Company”) witness Daday on March 19, 2019. Specifically, I will focus on ORS’s adjustment to PWR’s revenue requirement attributable to the excess revenue component of the Tax Cuts and Jobs Act (“TCJA”).

Q. PLEASE CLARIFY ORS'S RECOMMENDATION TO ESTABLISH A REGULATORY LIABILITY AND ADJUST THE REVENUE REQUIREMENT FOR PWR.

A. The change in the federal tax rate was extraordinary and beyond the control of PWR. Additionally, the federal tax rate reduction caused a material known and measurable change in the Company's federal income tax expense. The Company has collected for federal taxes that it will never pay. ORS recommends the ratepayer receive the benefit of the change in income tax expense effective January 1, 2018. To provide the full benefit to ratepayers, ORS calculated the revenue billed to PWR customers attributed to the change in federal income tax rate from the previously approved federal tax rate (34%) to 21%. Consistent with Commission Order No. 2018-308, ORS recommends \$231,707 be placed into a regulatory liability and amortized over three (3) years as discussed in my direct testimony.

ORS recommends a reduction to the Company's future revenue requirement, which is purely prospective. ORS has not requested a retro-active return of the regulatory liability. ORS's recommendation will return the benefits to the ratepayer and prevent PWR from receiving a windfall, at its customer's expense, solely due to the TCJA. ORS requested the Commission order the rates in effect as of January 1, 2018, be subject to refund so that ratepayers received the benefits of the tax changes due to the TCJA. The Commission granted ORS's petition in Order No. 2018-26 on January 10, 2018. The ORS recommendation that the benefits to the ratepayers from the TCJA be incorporated in revenue adjustments in a subsequent rate proceeding does not constitute retroactive rate

1 making because ORS recommends a reduction to the Company's future revenue
2 requirement, which is purely prospective.

3 Further, the Commission ordered that the utilities should track and defer the effects
4 resulting from the TCJA in a regulatory liability account in Order No. 2018-308. In
5 reviewing the Company's books and records ORS was unable to find any appropriate
6 regulatory liability accounts on the Company's balance sheet. As a result, ORS calculated
7 and provided the appropriate calculations of the liability for this Commission.

8 **Q. DO YOU AGREE WITH COMPANY WITNESS DADAY'S CONTENTION THAT**
9 **THE CHANGE IN THE CORPORATE TAX RATE DID NOT RESULT IN PWR**
10 **EARNINGS IN EXCESS OF ITS AUTHORIZED?**

11 **A.** No. ORS utilized the last Commission approved cost of service study to determine
12 the appropriate value of the Company's revenues that are attributed to federal income taxes.
13 As it stands, a portion of the Company's rates were designed to cover a federal income tax
14 rate of 34% that the Company will never pay to the Internal Revenue Service.

15 The approved operating margin in the Company's last rate case represents the
16 amount the Company has the potential to earn, with efficient management. It does not
17 represent guaranteed revenue or return for the Company. The actual return earned by a
18 utility fluctuates over time and may fall below or exceed the approved rate of return.
19 Nevertheless, it is ultimately the Company's choice as to when it should request a general
20 rate increase and evaluation of the authorized operating margin.

21 The tax collection was designed to pay for PWR's tax obligations to the IRS.
22 Therefore, taxes paid by PWR's customers were not intended to boost utility earnings.

Efficient management practices are the key to the Company earning its authorized return.
ORS recommends any savings from the TCJA be returned to customers in a timely manner.

**Q. HAVE OTHER COMMISSIONS RULED ON THE TIMING AND METHOD OF
RETURN OF EXCESS REVENUES ATTRIBUTE TO THE TCJA?**

A. Yes. The North Carolina Utilities Commission (“NCUC”) on February 21, 2019 issued an order in Docket No. W-354, Sub 360 regarding the application of Carolina Water Service, Inc. of North Carolina (“CWSNC”) for an increase in water and sewer rates. In that Order on page 110, provided in Surrebuttal Exhibit MPS-1, the NCUC ordered:

6. That CWSNC shall refund to ratepayers the overcollection of federal income taxes related to the decrease in the federal corporate income tax rate for the period beginning January 1, 2018, including interest at the overall weighted cost of capital, as a credit to customers’ bills for a one-year period beginning when the new rates become effective in the present docket;

On pages 56 through 59, the NCUC had additional extensive discussion on the matter, provided as Surrebuttal Exhibit MPS-1. Specifically, the NCUC addressed retroactive ratemaking, accrual of interest in the customer’s favor, and the return within twelve months of when the over-collection was generated. Further, NCUC determined the return of the over-collection were not predicated on Carolina Water Service, Inc. overearning. ORS believes the position adopted by the NCUC is reasonable and in the public interest and, therefore, recommends the Commission adopt a similar position to that of the NCUC on the TCJA issues raised by the Company.

**Q. WILL YOU UPDATE YOUR SURREBUTTAL TESTIMONY BASED ON
INFORMATION THAT BECOMES AVAILABLE?**

1 **A.** Yes. ORS fully reserves the right to revise its recommendations via supplemental
2 testimony should new information not previously provided by the Company, or other
3 sources, become available.

4 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

5 **A.** Yes, it does.

**STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH**

DOCKET NO. W-354, SUB 360

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of
Application by Carolina Water Service, Inc., of) ORDER APPROVING JOINT
North Carolina, 4944 Parkway Plaza Boulevard,) PARTIAL SETTLEMENT
Suite 375, Charlotte, North Carolina 28217, for) AGREEMENT AND STIPULATION,
Authority to Adjust and Increase Rates for) GRANTING PARTIAL RATE
Water and Sewer Utility Service in All of its) INCREASE, AND REQUIRING
Service Areas in North Carolina, Except Corolla) CUSTOMER NOTICE
Light and Monteray Shores Service Area)

HEARD: Tuesday, August 28, 2018, at 7:00 p.m., in the Craven County Courthouse,
Courthouse Annex, Courtroom #4, 302 Broad Street, New Bern, North
Carolina

Wednesday, August 29, 2018, at 7:00 p.m., in Courtroom 317,
New Hanover County Courthouse, 316 Princess Street, Wilmington, North
Carolina

Wednesday, September 19, 2018, at 7:00 p.m., in the Mecklenburg County
Courthouse, Courtroom 5350, 832 East 4th Street, Charlotte,
North Carolina

Tuesday, September 25, 2018, at 7:00 p.m., in the Watauga County
Courthouse, Courtroom #1, 842 W. King Street, Boone, North Carolina

Wednesday, September 26, 2018, at 7:00 p.m., in the Buncombe County
Courthouse, Courtroom 1A, 60 Court Plaza, Asheville, North Carolina

Monday, October 8, 2018, at 7:00 p.m., and Tuesday, October 16, 2018, at
10:00 a.m., in Commission Hearing Room 2115, Dobbs Building, 430 North
Salisbury Street, Raleigh, North Carolina

BEFORE: Chairman Edward S. Finley, Jr., Presiding, and Commissioners ToNola D.
Brown-Bland, Jerry C. Dockham, James G. Patterson, Lyons Gray, Daniel
G. Clodfelter, and Charlotte A. Mitchell

should be flowed back to ratepayers as quickly as practicable. The fact that the Company has made use of these funds as cost-free capital does not change the fact that these funds are ultimately customer money that is no longer needed for tax payments. The only remaining question for the Commission to decide is what is a reasonable period of time to refund these federal unprotected EDIT to ratepayers.

The Commission has carefully considered the evidence as to the appropriate time period over which to return federal unprotected EDIT. The evidence shows that all of the parties agree that the timeframe should be within a two-year to five-year range. Specifically, the Public Staff recommends three years, the AGO recommends two years, and the Company, if its offsetting proposal is not adopted, recommends five years. The Company no longer needs these funds to pay its taxes, which is why they were collected from ratepayers in the first place. Therefore, based on the evidence in this case, the Commission finds that it is appropriate in this case to return federal unprotected EDIT over a four-year period through a levelized rider. The Commission finds that this decision appropriately balances the interests of ratepayers and the Company. By removing the total amount of the federal unprotected EDIT credit from rate base in the current case, the Company will be provided with an increase in rates to moderate any cash flow issues, to the extent they would exist. Further, the Commission finds that requiring the flowback over four years provides the Company with additional time to return the money and is the appropriate timeframe to balance both the Company's and the ratepayer's interests.

State EDIT - Additionally, the Commission does not find it appropriate to adopt witness DeStefano's proposal to utilize the state EDIT to offset various unamortized deferred maintenance assets in the current proceeding. The Commission has previously approved the amortization of state EDIT in the Sub 356 proceeding, and does not find any of the evidence presented in this proceeding persuasive to change the decision reached by the Commission in that docket.

In arriving at its conclusion, the Commission gives substantial weight to the testimony of witness Boswell. The Commission agrees with witness Boswell that CWSNC's proposal to offset the state EDIT against deferred regulatory assets presents significant intergenerational issues and constitutes inappropriate ratemaking. The Commission also agrees with the Public Staff and the AGO that there is no compelling reason to change the amortization of the state EDIT in this proceeding.

Therefore, the Commission finds that the state EDIT regulatory liability should continue to be amortized over a three-year period as approved in the Sub 356 Order.

Provisional Amount – Finally, the Commission finds that it is appropriate to require CWSNC to return the overcollection of federal taxes related to the decrease in the federal corporate income tax rate, including interest calculated at the overall weighted cost of capital, as a credit over a one-year period beginning when new base rates become effective. The rates with respect to the federal income tax expense have been provisional based on the Commission's generic order, so retroactive ratemaking is not at issue.

The Commission notes that CWSNC witness DeStefano specified during cross-examination by the AGO that the Company will have approximately \$1.26 million in provisional revenues for the 2018 calendar year. In reaching its conclusion on this issue, the Commission notes that in its generic order issued in Docket No. M-100, Sub 148 on January 3, 2018, the Commission ordered all utility rates based on the federal corporate income tax rate of 35% rather than the Congressionally approved 21%, effective January 1, 2018, to be provisional and required accompanying deferred accounting for the amount of reduced rates. This meant that the Commission in subsequent orders could require refunds of revenues collected after January 1, 2018 to return to customers the portion of rates providing revenues to cover federal income tax expense greater than 21%. The North Carolina Supreme Court in State ex rel. Utilities Com. v. Nantahala Power & Light Co., 326 N.C. 190, 388 S.E.2d 118, 1990 N.C. LEXIS 12, 110 P.U.R.4th 250, ruled that this procedure in a generic rulemaking case is appropriate with respect to a similar federal income tax reduction with respect to the Tax Reform Act of 1986. The Court rejected challenges to the Commission's order requiring generic rate reductions as constituting single-issue rate adjustments. The Court held, however, that should utilities wish to demonstrate that their overall rate level not be reduced to reflect lower federal income tax expense, the remedy was to file a general rate case.

In this case, CWSNC has filed a general rate case, and the cost of service evidence justifies a rate increase, thus offsetting the reduction in cost of service from the tax rate decrease with increases elsewhere.

CWSNC nevertheless wishes to retain the overcollected, provisional revenues from January 1, 2018 to October 16, 2018. CWSNC's theory is that it failed to recover its overall cost of service during that period. The Commission determines that the Company's proposed justification to permit CWSNC to retain the revenues at issue is inapposite. The Commission uses the historic test year as adjusted through the end of the hearing to set rates prospectively, effective as of the date of this rate case Order. The reduction in federal income tax expense to 21% is an ongoing reduction in cost of service. To authorize the Company to effectively add a surcharge in rates beginning on January 1, 2018 with respect to this expense item would be no different than authorizing a surcharge for recovery of rates covering a decrease in labor costs during the test year as adjusted.

In addition, on cross-examination by the Public Staff, witness DeStefano noted that an affiliate of CWSNC pointed him to a recent Order by the RCA wherein that Commission declined to make a portion of the revenues received by two water utilities refundable pursuant to the Tax Act. The Commission gives little weight to witness DeStefano's testimony concerning the August 28, 2018 Order by the RCA. Witness DeStefano agreed during cross-examination that the utilities that were granted the favorable treatment by the RCA are distinguishable from CWSNC's case in this instance. First, the Alaska decision addresses two specific water utilities wherein the RCA opened the dockets and held show cause proceedings to investigate if the rates charged by the two utilities remained just and reasonable given the reduction to the annual revenue requirement caused by the Tax Act. In contrast, in North Carolina, in response to the Tax Act, the

Commission established a generic rulemaking docket (Docket No. M-100, Sub 148) on January 3, 2018, and in the Order establishing the docket, the Commission put the utilities on notice that any revenues collected on and after January 1, 2018, were to be considered provisional pending a final ruling by the Commission. In addition, the two Alaskan utilities had not been in for rate cases since 2014, and both companies are required to file their next rate case by July 1, 2020, if not sooner. Witness DeStefano also stated on cross-examination that he was not aware of any other state besides Alaska to make this decision, although he did not think he had “uncovered every stone” on this issue and that a lot of states are still working through this process. Witness DeStefano also agreed that he is aware of several other states that are ordering their utilities to refund these provisional amounts.

In fact, in North Carolina, the Commission has required other utilities in its October 5, 2018 Order issued in Docket No. M-100, Sub 148 to return the provisional amount collected since January 1, 2018, with interest reflected at each company’s overall weighted cost of capital as approved in the company’s last general rate case proceeding, in each utility’s next general rate case proceeding or in three years, whichever is sooner.

Addressing CWSNC witness DeStefano’s proposal to use a short-term interest rate instead of the overall weighted cost of capital for the provisional amount, the Commission notes that on cross-examination by the Public Staff, witness DeStefano stated that he does not have a proposed short-term interest rate offhand to apply to the provisional amount in question in this proceeding. He specified that the rate could be anything that would reflect the retention of funds for one calendar year or less. Witness DeStefano stated that in this case applying the cost of capital rate seems too high for something that is refunded within a 12-month period from when it was generated. Witness DeStefano specified that the short-term borrowing rate would be less than the overall weighted cost of capital and could be very low, in the 2% range. Both the Public Staff and the AGO disagreed with witness DeStefano on using a short-term interest rate for the provisional amount.

After reviewing the record of evidence on this issue, the Commission finds that the Company’s recommendation that the interest on any refund be calculated using a short-term debt rate is not appropriate or reasonable to ratepayers when the Company earns a return on its rate base, based on the overall weighted cost of capital. In reaching this conclusion, the Commission gives substantial weight to the testimony of the Public Staff’s witness and the arguments of the AGO.

The Commission also notes that it recently required Cardinal Pipeline Company, LLC, to return to ratepayers the provisional amount that it voluntarily decided to return now instead of under the parameters of the October 5, 2018 Order with interest reflected at the company’s overall weighted cost of capital as approved in its last general rate case proceeding (See Docket Nos. G-39, Sub 42 and M-100, Sub 148).

In summary, the Commission finds and concludes that these decisions concerning the Tax Act are appropriate and provide for the full flowback to ratepayers of the effects

of the Tax Act. As noted in Public Staff witness Casselberry's supplemental testimony, many of the public witnesses that testified at the public hearings in New Bern and Charlotte noted the tax reductions due to the Tax Act. The decisions herein address those concerns expressed by the various public witnesses in this proceeding and do provide a full flowback to ratepayers of the decrease in the federal corporate income tax rate resulting from the Tax Act.

EVIDENCE AND CONCLUSIONS FOR FINDINGS OF FACT NOS. 52 – 60

The evidence supporting these findings of fact and conclusions is found in the Application and the accompanying NCUC Form W-1 of the Company, the testimony and exhibits of the public witnesses, the testimony and exhibits of Company witness D'Ascendis, the testimony and exhibits of Public Staff witness Hinton, and the entire record of this proceeding.

Rate of Return on Equity

In its Application and in the direct testimony of CWSNC witness D'Ascendis, the Company requested approval for its rates to be set using a rate of return on equity in a range of 11.50% to 11.90%. In his rebuttal testimony, witness D'Ascendis reduced his recommended rate of return on equity to a range of 10.80% to 11.20% after updating his analysis and making several changes to the application of his models. For the reasons set forth herein, the Commission finds that a rate of return on equity of 9.75% is just and reasonable.

Rate of return on equity, also referred to as the cost of equity capital, is often one of the most contentious issues to be addressed in a rate case. In the absence of a settlement agreed to by all parties, the Commission must exercise its independent judgment and arrive at its own independent conclusion as to all matters at issue, including the rate of return on equity. See, State ex rel. Utils. Comm'n v. Carolina Utils. Customers Ass'n, 348 N.C. 452, 466, 500 S.E.2d 693, 707 (1998). In order to reach an appropriate independent conclusion regarding the rate of return on equity, the Commission should evaluate the available evidence, particularly that presented by conflicting expert witnesses. State ex rel. Utils. Comm'n v. Cooper, 366 N.C. 484, 491-93, 739 S.E.2d 541, 546-47 (2013) (Cooper I). In this case, the evidence relating to the Company's cost of equity capital was presented by CWSNC witness D'Ascendis and Public Staff witness Hinton. No other rate of return on equity expert evidence was presented by any party.

In addition to its evaluation of the expert evidence, the Commission must also make findings of fact regarding the impact of changing economic conditions on customers when determining the proper rate of return on equity for a public utility. Cooper I, 366 N.C. at 494, 739 S.E.2d at 548. This was a factor newly announced by the Supreme Court in its Cooper I decision and not previously required by the Commission or any appellate courts as an element that must be considered in connection with the Commission's determination of an appropriate rate of return on equity. The Commission's

IT IS, THEREFORE, ORDERED as follows:

1. That the Partial Joint Settlement Agreement and Stipulation is incorporated by reference herein and is hereby approved in its entirety;
2. That the Partial Joint Settlement Agreement and Stipulation, filed on September 17, 2018, and the parts of this Order pertaining to the contents of that agreement shall not be cited or treated as precedent in future proceedings;
3. That the Schedules of Rates, attached hereto as Appendices A-1, A-2, A-3, and A-4, and the Schedules of Connection Fees for Uniform Water and Uniform Sewer, attached hereto as Appendices B-1 and B-2, are hereby approved and deemed to be filed with the Commission pursuant to N.C.G.S. § 62-138, and are hereby authorized to become effective for service rendered on and after the issuance date of this Order;
4. That the Notices to Customers, attached hereto as Appendices C-1 and C-2 shall be mailed with sufficient postage or hand delivered to all affected customers in each relevant service area, respectively, in conjunction with the next regularly scheduled billing process;
5. That CWSNC shall file the attached Certificate of Service, properly signed and notarized, not later than 10 days after the Notices to Customers are mailed or hand delivered to customers;
6. That CWSNC shall refund to ratepayers the overcollection of federal income taxes related to the decrease in the federal corporate income tax rate for the period beginning January 1, 2018, including interest at the overall weighted cost of capital, as a credit to customers' bills for a one-year period beginning when the new rates become effective in the present docket;
7. That the decision reached by the Commission in CWSNC's Sub 356 Order to amortize over three years the Company's state EDIT recorded pursuant to the Commission's Sub 138 Order shall remain in full force and effect;
8. That the unprotected EDIT associated with the reduction in the federal corporate income tax rate shall be returned by CWSNC to ratepayers through a levelized rider to rates over a four-year period;
9. That the protected federal EDIT shall be amortized by CWSNC over 45 years in accordance with the IRC;
10. That in CWSNC's next general rate case proceeding, CWSNC and the Public Staff shall evaluate in detail and determine the appropriate methodology to calculate CIAC and PAA amortization expense for the post-merger entity on a going-forward basis for ratemaking purposes in order to ensure that contributed property is depreciated at the same rate that the related CIAC is amortized;